(11)

No. 96-454



In The

# Supreme Court of the United States

October Term, 1996

ASSOCIATES COMMERCIAL CORPORATION,

*Petitioner,*

v.

ELRAY RASH and JEAN E. RASH,

*Respondents.*

On Writ Of Certiorari
To The United States Court Of Appeals
For The Fifth Circuit

## BRIEF OF AMICI CURIAE IN SUPPORT OF PETITIONER

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# BRIEF OF AMICI CURIAE IN SUPPORT OF PETITIONER

The American Automobile Manufacturers Association, Inc. ("AAMA"), the Association of International Automobile Manufacturers, Inc. ("AIAM") and the American Financial Services Association ("AFSA") submit this Brief of Amici Curiae in Support of Petitioner. This brief is filed under Rule 37.3(a). The written consents of all parties to the filing of this brief have been filed with this Court's clerk.

## I

## INTEREST OF AMICI CURIAE

AAMA is an association of the three major American car manufacturers, Ford Motor Company, General Motors Corporation and Chrysler Corporation which together produce more than 80% of the cars manufactured in the United States. Through their finance subsidiaries, each of the AAMA's members finances the purchase of millions of cars each year. Each year, the AAMA's members are involved, as undersecured creditors, in tens of thousands of Chapter 13 bankruptcy cases, most of which involve the valuation issue presented by this case.

AIAM is a trade association representing United States subsidiaries of international automobile companies, including American Honda Motor Co., Inc., American Suzuki Motor Corporation, BMW of North America, Inc., Daewoo Motor Co., Ltd., Fiat Auto U.S.A., Inc., Hyundai Motor America, Isuzu Motors America, Inc., Kia Motors America, Inc., Land Rover North America, Inc., Mazda Motor of America, Inc., Mitsubishi Motor

Sales of America, Inc., Nissan North America, Inc., Peugeot Motors of America, Inc., Porsche Cars North America, Inc., Rolls-Royce Motor Cars, Inc., Subaru of America, Inc., Saab Cars USA, Inc., Toyota Motor Sales U.S.A., Inc., Volkswagen of America, Inc., and Volvo North America Corporation. Like the members of the AAMA, these international car makers finance the purchase of thousands of cars and are likewise involved in thousands of Chapter 13 cases annually, in most of which the car's value is in issue.

AFSA is the nation's largest trade association representing non-bank providers of consumer financial services. Organized in 1916, AFSA represents more than 360 companies operating over 10,000 offices engaged in extending consumer credit. AFSA's members include credit card issuers, independently-owned consumer finance companies, diversified financial services companies, and automobile finance companies. Consumer finance companies hold over $190 billion of outstanding consumer credit and over $50 billion in second mortgage credit representing one quarter of all consumer credit outstanding in the United States.

Amici and their members have a vital interest in the outcome of the issue raised in this case. Members of amici are involved as secured creditors in thousands of Chapter 13 proceedings each year. In 1995 alone, over 286,000 new Chapter 13 cases were filed. Bankruptcy Statistical Information, *reprinted in* 1995 Admin. Off. Of U.S. Cts., JCUS Rep. 93, Table F-2.

Most of those proceedings involve the valuation issue which this case raises. Most commonly, the debtor's



car is the focus of the valuation dispute. Consumer debtors need their cars to continue working and living a normal modern life. Hence, most Chapter 13 plans provide for the debtor to retain his or her car and pay the creditor reduced monthly principal payments based on the car's value, as determined under 11 U.S.C. § 506(a).

If the debtor retained his or her car in just half of the new Chapter 13 cases last year and the average difference between wholesale and retail value was $2,000, the choice between these valuation standards would have made a $286 million difference to debtors and creditors in 1996 alone. Creditors cannot simply "absorb" losses of this magnitude. Creditors' losses inevitably increase the cost of credit to all borrowers, solvent and insolvent alike.

The standard of valuation under 11 U.S.C. § 506(a) affects all collateral, not just cars, and all types of bankruptcy cases, not just Chapter 13 filings. Homes and other real property must also be valued to determine how much of a creditor's claim is secured.[1] Many of amici's members also provide financing secured by these other forms of collateral. The standard for valuation of collateral retained by a debtor under a Chapter 13 plan should be the same no matter what type of property is involved. Cars should not be valued by one standard, homes by another, and equipment or other assets by a third.

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[1] Valuation of the debtor's home is less commonly an issue in Chapter 13 cases because 11 U.S.C § 1322(b)(2) does not permit a Chapter 13 plan to modify the rights of a creditor whose only security is the debtor's home. *Nobleman v. American Savings Bank*, 508 U.S. 324, 113 S.Ct. 2106, 124 L.Ed.2d 228 (1993).

For all of these reasons, amici have a vital interest in the issue raised in this case.

## II
## SUMMARY OF ARGUMENT

Section 506(a) of the Bankruptcy Code provides that a creditor's allowed claim

> is a secured claim to the extent of the value of *such creditor's interest in the estate's interest in the collateral*. . . . Such value shall be determined *in light of* the purpose of the valuation and of *the proposed disposition or use of such property*. . . . (Emphasis added.)

Properly construed, § 506(a)'s two sentences provide a clear, consistent, and coherent directive as to how a court is to value the secured portion of an undersecured creditor's claim. The section's first sentence identifies ***what*** is to be valued: "the creditor's interest in the estate's interest in the collateral." The second sentence states ***how*** the value of the creditor's interest is to be determined: "in light of the purpose of the valuation and of the proposed disposition or use of such property."

The Court of Appeal's majority opinion incorrectly reads more into § 506(a)'s first sentence, wrongly equating "the creditor's interest" with the right to foreclose upon and sell the collateral. *United Savs. Ass'n v. Timbers of Inwood Forest Assoc.*, 484 U.S. 365, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988) ("*Timbers*") teaches that § 506(a) cannot be so read. Doing so, nullifies § 506(a)'s second sentence. Moreover, under standard non-bankruptcy law, the creditor's interest indisputably comprehends more



than simply the right to foreclose and sell. *See Nobleman v. American Savings Bank, supra*, 113 S.Ct. at 2109-10 (secured creditor's "rights" include more than the right to foreclose).

Once the function of § 506(a)'s first sentence is properly understood, the role of its second sentence becomes clear, too. The collateral must be valued "in light of the purpose of the valuation and of the proposed disposition or use of such property."

If the debtor proposes to retain and use the collateral, the collateral must be valued in light of that proposed use. Its value is the amount that the debtor or others in his or her position would pay to obtain the property; that is, the collateral's fair market value in the market in which the debtor would buy such goods.[2] If the debtor owns less than a full fee interest or the creditor's interest is limited, the value of those limitations must be established in the same manner and be subtracted from the collateral's value to derive the value of the "creditor's interest."

Interpreting § 506(a) in this manner not only reconciles its provisions into a harmonious whole, but also furthers Congress' stated intention of allowing creditors to share in the enhanced value generated by a debtor's proceeding under Chapter 13 rather than under Chapter 7. Granting secured creditors a portion of the enhanced

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[2] For example, if the debtor proposes to retain and use a car, the value of the secured portion of the creditor's claim in that car is the fair market value of that car in the used car market in which debtor could buy an identical car if unable to retain his or her own.

value due to reorganization compensates them, in part, for the increased risks they incur in reorganization. This represents no windfall to creditors. Valuation is primarily of concern when the creditor is undersecured, as petitioner is in this case. In this case, as in the typical Chapter 13 case, the debtor pays little or nothing on unsecured claims. Undersecured creditors, therefore, usually lose most of the unsecured part of debt; that is, the amount that exceeds the collateral's value. In addition, undersecured creditors have additional credit risks under Chapter 13 plans. Those risks are particularly acute when the collateral is a rapidly depreciating asset such as a car. Less than a third of Chapter 13 debtors complete their plans. In the other two-thirds of the Chapter 13 cases, creditors often suffer further losses upon later repossessing collateral which has not been adequately maintained or insured during the pendency of the Chapter 13 case.

Finally, the valuation issue cannot properly be resolved by splitting the difference between wholesale and retail values, as the Seventh Circuit has suggested, *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996), or by leaving bankruptcy courts to choose any value they please between wholesale and retail values, as the Second Circuit has more recently held, *In re Valenti*, ___ F.3d ___, 1997 WL 31577 (2d Cir. 1997). Both of these approaches fail to accord coherent meaning to § 506(a), engaging in judicial legislation to fill the gap they wrongly perceive in the statute that Congress enacted.

For all of these reasons, amici urge the Court to reverse the Court of Appeal decision in this case and hold that for purposes of valuing the secured portion of an undersecured creditor's claim, collateral retained by a



debtor under a Chapter 13 plan must be valued at its fair market value in the market in which the debtor would, but for the Chapter 13 plan, acquire identical property.

## III
## PROPERLY INTERPRETED, SECTION 506(a) IS A CONSISTENT WHOLE

### A. Section 506(a)'s First Sentence Identifies What Is To Be Valued

#### 1. The Court Must Value The Collateral, Deducting For Limitations In The Estate's Or The Creditor's Interest In That Collateral

Section 506(a)'s first sentence states that a creditor's allowed claim secured by a lien on the estate's property "is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property."

This sentence marks the dividing line between the secured and unsecured portions of an undersecured creditor's claim. It states ***what*** the bankruptcy court must value in order to determine how much of a creditor's claim is secured.

The first sentence does ***not*** indicate ***how*** that value is to be determined. As Collier explains, § 506(a)'s first sentence deals with "several factors ***other than the methodology and basis of valuation.***" 3 Collier On Bankruptcy, ¶ 506.04[1] at 506-17 (15th ed. 1990) (emphasis added).

Congress used the phrase "creditor's interest in the estate's interest in such property" to provide for the various circumstances in which the creditor has an interest in less than the full intrinsic value of the collateral. For example, the debtor may own less than an undivided fee interest in the collateral. *See* 3 Collier On Bankruptcy, *supra*, ¶ 506.04[1] at 506-17 – 506-18. Such limited estates are a common feature of real property ownership. The value of a creditor's interest in the collateral cannot exceed the value of the debtor's or the estate's interest in it.

Likewise, the creditor's lien may encumber less than the full value of the debtor's interest in the collateral. The creditor's lien may be junior or subordinate to other liens on the same property. In *In re Taffi*, 96 F.3d 1190, 1191 (9th Cir. 1996), for example, the IRS' lien was subordinate to $233,942 in senior liens. The value of the IRS' lien was not the full value of the collateral because the senior debt had to be paid before the IRS received any value from the collateral. The IRS' "interest in the collateral" had less value than the interest of the creditor holding the senior lien encumbering the same property.

This is the meaning of § 506(a)'s first sentence. That sentence's reference to "the value of such creditor's interest in the estate's interest in the collateral" serves to emphasize that neither the debtor nor the creditor may have rights in the collateral's full intrinsic value. The sentence directs the bankruptcy court to make appropriate deduction for such limitations in valuing the creditor's security.



*Timbers* confirms this interpretation of § 506(a)'s first sentence. Construing the similar wording of 11 U.S.C. § 362(d), the Court said, "The term 'interest in property' certainly summons up such concepts as 'fee ownership,' 'life estate,' 'co-ownership,' and 'security interest' more readily than it does the notion of 'right to immediate foreclosure.' " 484 U.S. at 371. Just so. If "the estate's interest in such property" is a life estate or co-ownership, § 506(a) directs the bankruptcy court to value that diminished interest in the collateral, not the collateral's full intrinsic value. Likewise, if the creditor holds a subordinate security interest, § 506(a)'s first sentence mandates that the subordinate interest be valued, not the full fee. That is the sole function of § 506(a)'s first sentence – to describe ***what*** must be valued.

### 2. The Creditor's Interest In The Collateral Is Not Limited To The Collateral's Value Upon Foreclosure Sale

The Fifth Circuit's en banc majority opinion wrongly ascribes an additional meaning to § 506(a)'s first sentence. It equates "creditor's interest" with the right to foreclose upon and sell the collateral and holds that valuation of the "creditor's interest" must "start[] with what the creditor could realize by repossession and sale of the collateral." Pet. App., 14a, 28a (fn. omitted).

This extra step is wrong as a matter of statutory construction and as a matter of non-bankruptcy law.

### a. The Creditor's Interest In The Collateral Cannot Mean Just The Right To Foreclose And Sell The Collateral

In equating "creditor's interest in the property" with the right to foreclose upon and sell the collateral, the Fifth Circuit majority opinion attributes to the quoted phrase the one meaning which this Court ruled out in *Timbers*:

> In subsection (a) of this provision [§ 506(a)] ***the creditor's "interest in property" obviously means his security interest without taking account of his right to immediate possession of the collateral on default***. If the latter were included, the "value of such creditor's interest" would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues – since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time. No one suggests this was intended. ***The phrase "value of such creditor's interest" in § 506(a) means "the value of the collateral."*** [Citations.]

484 U.S. at 372, 108 S.Ct. at 631 (emphasis added).

As *Timbers* suggests, if Congress had intended to have the bankruptcy court value the creditor's "remedy" of foreclosure and sale, it would have used that term or some similar language, not the term "creditor's interest." "Creditor's interest" "summons up such concepts as 'fee ownership,' 'life estate,' 'co-ownership,' and 'security interest' more readily than it does the notion of 'right to immediate foreclosure.' " 484 U.S. at 371.



Furthermore, if the creditor's interest is equated with the right to foreclose and sell the collateral, § 506(a)'s second sentence is nullified. Under that reasoning, value is always determined by the foreclosure sale price of the collateral, no matter what the proposed disposition or use. *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 76 (1st Cir. 1995); *In re Trimble*, 50 F.3d 350, 532 (8th Cir. 1995). Such an interpretation "violates the settled rule that a statute must, if possible, be construed in such fashion that every word has some operative effect." *United States v. Nordic Village, Inc.*, 503 U.S. 30, 112 S.Ct. 1011, 1015, 117 L.Ed.2d 181 (1992); *Hoffman v. Connecticut Dept. of Income Maintenance*, 492 U.S. 96, 103, 109 S.Ct. 2818, 2823-24, 106 L.Ed.2d 76 (1989).[3]

Attempting to accord § 506(a)'s second sentence *some* meaning, the Fifth Circuit majority suggested that the debtor's proposed use of the collateral can affect valuation of the creditor's interest in those instances in which the "'the debtor's use of the collateral may be particularly beneficial, or particularly detrimental, to its value. For example, the collateral may consist of equipment which is being used by the debtor twenty-four hours per day, so

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[3] The general principle that all statutory words are to be given effect is especially applicable in this instance. Section 506(a)'s second sentence was added to the House Bill in the Senate, was mentioned in the Senate Report on the bill, and was retained by the conference committee. *Compare* H.R. 8200, 95th Cong. 1st Sess., § 506(a), p. 387 (1977) with S. 2266, 95th Cong., 2d Sess., § 506(a), p. 394 (1978); S. Rep. 95-595, 95th Cong., 2d Sess., 68 (1978); *see* 124 Cong. Rec. S 17411 (daily ed. Oct. 6, 1978). Plainly, Congress attached considerable significance to the addition of § 506(a)'s second sentence. The courts must do so as well.

that its use is causing rapid deterioration.'" Pet. App., 25a, quoting J. F. Queenan, *Standards for Valuation of Security Interests in Chapter 11*, 92 Com. L. J. 18, 37 (1987).

This effort to give *some* meaning to § 506(a)'s second sentence is fatally flawed. First, it still leaves § 506(a)'s second sentence only "trivial application" and should be rejected for that reason alone. *See United States v. Nordic Village, Inc., supra*, 112 S.Ct. at 1015. It is highly unlikely that the Senate would have added § 506(a)'s second sentence and that the conference committee would have retained that change for the sole purpose of dealing with the highly unusual situations of particularly beneficial or detrimental use by the debtor.

Second, this effort is at odds with the Fifth Circuit majority's basic theory that what is being valued is the creditor's right to foreclose and sell the collateral. The foreclosure sale price is not increased if the debtor puts the collateral to a "particularly beneficial" use. Foreclosure will remove the collateral from the debtor's hands and place the collateral in others' hands. Their less beneficial use of the collateral will determine its foreclosure sale price.

Similarly, a debtor's "particularly detrimental" use of the collateral will not affect the foreclosure sale price because foreclosure will end that use.[4] If the debtor's

[4] The Fifth Circuit majority did not explain how the value of the creditor's interest would be affected by a "particularly detrimental" use. Would the value decrease to reflect the higher rate of depreciation? Or would the value increase to reflect the creditor's greater risk? The Fifth Circuit majority's silence on this crucial point illustrates the logical inconsistency between its proposed meaning for § 506(a)'s second sentence and the meaning it wrongly ascribed to the section's first sentence.



detrimental use increases depreciation of the collateral's value, the bankruptcy court should order repayment of the collateral's value over a commensurably shorter period or perhaps augment the adequate protection given the creditor instead of relief from the automatic stay, see Pet. App., 27a, but the value should not change as a result.

### b. Under Non-Bankruptcy Law, The Creditor's Interest In The Collateral Includes More Than The Right To Foreclose And Sell The Collateral

As a matter of non-bankruptcy law, it is also incorrect to equate a creditor's security interest solely with the right to foreclose and sell. As with fee ownership, *see Andrus v. Allard*, 444 U.S. 51, 66, 100 S.Ct. 318, 327, 62 L.Ed.2d 210 (1979), a security interest involves a bundle of rights, only one of which is the right to foreclose and sell. *See also Nobleman v. American Savings Bank, supra*, 113 S.Ct. at 2110 (secured creditor's "rights" include more than right to foreclose). *In re Green*, 151 B.R. 501, 505 (Bankr. D. Minn. 1993) recognized this fact:

> [A] lien is fundamentally a *security* interest which secures payment of an obligation. To value such an interest in property based solely on the amount that could be realized upon sale of the collateral ignores the value associated

with the right to receive the stream of payments that the lien secures.

Another stick in the secured creditor's bundle of rights is the right to repossess the personal property collateral and retain it in satisfaction of the debt.[5] Tex. Bus. & Comm. Code Ann., § 9.505; *Tannenbaum v. Economics Laboratory, Inc.*, 628 S.W.2d 769, 771 (Tex. 1982). If the collateral is real property, the creditor may credit bid at the foreclosure sale, and thus receive full title to the property in satisfaction of the debt. By these means, the creditor may, if it so chooses, obtain for itself the full retail or fair market value of the collateral either for its own use or for resale at retail prices.

Yet another stick in the secured creditor's bundle is the right to share in any appreciation of the collateral. *Dewsnup v. Timm*, 502 U.S. 410, 417, 112 S.Ct. 773, 778, 116 L.Ed.2d 903 (1992).

In many cases, the secured creditor chooses to foreclose and sell, obtaining a lower price, but quickly converting its security interest into money that can be reinvested more profitably elsewhere. But that is the

[5] The Fifth Circuit majority opinion suggests no rational means of valuing collateral when the creditor makes a practice of retaining collateral in satisfaction of the debt. Is the collateral to be valued at the full amount of the debt discharged when the creditor retains the collateral? Is the collateral to be valued at retail because the creditor may obtain retail prices on resale or may itself make a retail use of the collateral? Or is wholesale value to be applied even under these circumstances? The Fifth Circuit majority opinion and other cases following the same reasoning give no clue as to how the courts should solve this conundrum.



secured creditor's choice, not the limit or measure of its interest in the property.

It is simply not true that a creditor's interest in collateral equals only the right to foreclose and sell the property at foreclosure sale prices. Beyond misconstruing § 506(a), the Fifth Circuit majority opinion misinterprets the underlying non-bankruptcy law establishing secured creditors' rights in the collateral.

### B. Section 506(a)'s Second Sentence States How The Creditor's Interest Is To Be Valued

Section 506(a)'s second sentence states ***how*** a court is to value the collateral and any lesser interests in that collateral owned by the estate and the creditor: "Such value shall be determined in light of the purpose of the valuation and the proposed disposition and use of such property. . . . "

Following this clear direction causes little problem once it is seen that what is to be valued is ***not*** the creditor's right to foreclose and sell the collateral but instead the collateral or the estate's or creditor's less-than-total interest in the collateral.

In the context of the present case, the "purpose" of the valuation is to determine the amount that the secured creditor must be paid under the debtors' Chapter 13 plan, not to determine the amount the creditor would receive if it hypothetically had to repossess and sell the collateral. *In re Trimble, supra,* 50 F.3d at 632. The proposed disposition and use of the collateral is retention by the debtor, not foreclosure and sale.

When the debtor intends to retain the collateral, the value of the creditor's interest in the estate's interest in that collateral must be ascertained in accordance with that planned use, and not according to what might hypothetically happen if the exact opposite – foreclosure and sale – occurred. Courts that have properly focused on § 506(a)'s second sentence have so held. *E.g., In re Taffi, supra*, 96 F.3d at 1192;[6] *In re Winthrop Old Farms Nurseries, Inc., supra*, 50 F.3d at 75; *In re Coker*, 973 F.2d 258, 260 (4th Cir. 1992); *In re Balbus*, 933 F.2d 246, 251 (4th Cir. 1991); *In re McClurkin*, 31 F.3d 401, 405 (6th Cir. 1994); *Lomas Mortgage USA v. Wiese*, 980 F.2d 1279, 1285 (9th Cir. 1992), *vacated on other grounds*, 113 S.Ct. 2925, 124 L.Ed.2d 676 (1993).

The value of collateral that a debtor retains under a plan is the value of the collateral to the debtor – the amount the debtor would pay on the open market for that or similar property. If the collateral is a house, its value to the debtor is the full fair market sales price of the house, without any deduction for selling costs. *In re Winthrop Old Farms Nurseries, Inc., supra*, 50 F.3d at 74; *In re McClurkin, supra*, 31 F.3d at 405; *Lomas Mortgage USA v. Weise, supra*, 980 F.2d at 1285-86; *In re Balbus, supra*, 933

[6] "In this case, the key fact is that the debtors are going to possess the [collateral]. This fact determines the disposition and use of the creditor's interest. The foreclosure value is not relevant because no foreclosure is intended by the Plan. The [debtors] are in, not outside of, bankruptcy. The [creditor] is not foreclosing. Valuation must be accomplished within the actual situation presented. Consequently, the value has to be the fair market value of what the debtors are using." *In re Taffi, supra*, 96 F.3d at 1192.



F.2d at 252; *In re Case*, 115 B.R. 666, 669-70 (9th Cir. BAP 1990). That is the price the debtor would have to pay to buy, retain, and use the house outside of bankruptcy. That is the value that best reflects the debtor's intention to retain and use the property through the bankruptcy plan.

For the same reasons, if the collateral is a car, its value to a consumer debtor is the amount the debtor would have to pay to buy the car on the open market; generally speaking, its retail value. *In re Trimble, supra*, 50 F.3d at 532.

## IV

## PROPERLY INTERPRETED, SECTION 506(a) FULFILLS CONGRESS' INTENT TO ALLOW CREDITORS TO SHARE IN THE ENHANCED VALUE CREATED BY REORGANIZATION

The interpretation of § 506(a) suggested in the foregoing section of this brief not only harmonizes the section's two sentences, it also fulfills Congress' intent to permit creditors to share in the enhanced value created by reorganizations.

### A. Congress Intended Creditors To Share The Enhanced Value Of Collateral Retained Under A Chapter 13 Plan

In enacting the Bankruptcy Reform Act of 1978 and the Bankruptcy Amendments and Judgeship Act of 1984, Congress intended to encourage consumer debtors to file under Chapter 13 rather than under Chapter 7. *See* H.R. Rep. 595, 95th Cong., 1st Sess. 118, 125 (1977) *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6079, 6086;

130 Cong. Rec. H7499 (daily ed. June 29, 1984) (remarks of Rep. Anderson); 130 Cong. Rec. S8894 (daily ed. June 29, 1984) (remarks of Sen. Hatch), *reprinted in* 1984 U.S. Code, Cong. & Admin. News 590, 598.

As Congress recognized, proceeding under Chapter 13, rather than Chapter 7, should benefit both debtors and creditors. Chapter 13 proceedings help debtors avoid the stigma of bankruptcy and any resulting blot on their credit standing. Fulfillment of a Chapter 13 plan allows the debtor "to retain the pride attendant on being able to meet one's obligations." H.R. Rep. 595, *supra*, at 118; 1978 U.S. Code, Cong. & Admin. News at 6079.

Chapter 13 also benefits the debtor by allowing the debtor to retain his or her assets which are normally worth more to the debtor and cost more to replace than the price at which they can be sold. H.R. Rep. 595, *supra*, at 124; 1978 U.S. Code, Cong. & Admin. News at 6085.

Chapter 13 was also intended to aid creditors: "The benefit to creditors is self-evident: Their losses will be significantly less than if their debtors opt for straight bankruptcy." H.R. Rep. 595, *supra*, at 118; 1978 U.S. Code, Cong. & Admin. News at 6079.

Implementing this Congressional intent, section 1325(a)(4) requires that Chapter 13 plans provide *unsecured* creditors "not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title. . . . " As the House Report states, Chapter 13 allows debtors to propose realistic payment plans, but "[c]reditors will not be disadvantaged, because the plan must still pay them more than they would get under a liquidation." H.R. Rep. 595, *supra*, at 124; 1978 U.S. Code, Cong. & Admin. News at 6085.



Secured creditors must receive even better treatment than unsecured creditors under Chapter 13 plans;[7] hence, even better treatment than the secured creditor would receive under Chapter 7. Under Chapter 7, the secured creditor receives the collateral in kind or the net proceeds of its sale by the trustee, or the debtor keeps the collateral and reaffirms the debt. *See* 11 U.S.C. §§ 363, 524. Chapter 13 guarantees secured creditors more. Unless a secured creditor accepts the plan or the debtor surrenders the collateral, the plan must give the secured creditor a continuing lien in the collateral and provide for payment of an amount "not less than the allowed amount of such claim." 11 U.S.C. § 1325(a)(5)(B)(ii).

The allowed amount of the secured claim is determined under § 506(a), which directs that the value of the creditor's interest in the estate's interest in the collateral be determined in light of the purpose of the valuation and the proposed use or disposition of the property. The proposed use or disposition of the collateral under a Chapter 13 plan typically is retention by the debtor, a use which Congress recognized enhanced the value of the collateral – hence, benefited the debtor. By taking that value enhancement into account in setting the allowed

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[7] If secured creditors were not meant to receive better treatment under Chapter 13 plans than unsecured creditors, Congress would not have made separate provision for secured creditors in section 1325, but would have simply provided that all creditors should receive no less than they would upon liquidation under Chapter 7.

amount of secured claims for purposes of Chapter 13 plans, Congress achieved the sharing of benefits from reorganization which it intended to establish.

### B. The Sharing Of Enhanced Value Compensates Creditors For Additional Risks They Encounter Under Chapter 13 Plans

Sharing the enhanced value generated by reorganization, as Congress intended, compensates secured creditors for the additional risks they run in a Chapter 13 proceeding.

A Chapter 13 plan normally provides for the debtor to pay a secured creditor the value of its collateral over an extended period, typically three to five years. 11 U.S.C. § 1325(a)(5)(B)(ii). In the case of an undersecured creditor, the promised payments are already less than the amount of the original debt.

Like any promise, the debtor's promise to pay the collateral's value over a three-to-five-year period is worth less than cash in hand. Much less. After all, the debtor already defaulted once on his or her promises. The new promise is even less likely to be fulfilled.

As a group, Chapter 13 debtors are poor credit risks. Only about a third of Chapter 13 debtors complete their plans and receive a discharge.[8] The remaining two-thirds

[8] W.C. Whitford, The Ideal of Individualized Justice, 68 Am. Bankr. L.J. 397, 410-411 (1994); T. A. Sullivan, E. Warren & J. L. Westbrook, Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981- 1991, 68 Am. Bankr.



of Chapter 13 cases are dismissed or converted into Chapter 7 liquidations.

Because of the high risk of plan failure and default, a debtor's promise to pay foreclosure value, even with interest, over the course of the plan is inherently of less value than what a secured creditor would receive through straight liquidation – either the property or its value immediately.

Deterioration or depreciation of the collateral while the debtor proceeds under a Chapter 13 plan poses an additional, serious risk for secured creditors. In the two-thirds of Chapter 13 proceedings that fail, the creditor eventually must resort to its collateral for payment of the remaining debt after dismissal or conversion of the Chapter 13 case.

Secured creditors commonly find that the property has deteriorated or depreciated during the course of the plan far beyond the amount of any payments the secured creditor has received under the plan.[9] The reason is apparent. Chapter 13 proceedings fail because debtors lack funds to pay creditors the amounts promised under

L.J. 121, 143, 145 (1994); Admin. Off. Of U.S. Cts., Annual Report of the Director, 1991, at 296, Table F-2 (1992); T. A. Sullivan, E. Warren & J. L. Westbrook, *As We Forgive Our Debtors*, 222 (1989); Admin. Off. Of U.S. Cts., Annual Report of the Director, 1981, at 544, Table 2FA (1982).

[9] "Adequate protection" payments under 11 U.S.C. §§ 361, 362(d)(1) typically are based on the assumption that the collateral will be subject to only ordinary depreciation. Hence, even when such payments are made, they frequently fail to compensate adequately for the usually more rapid depreciation of assets retained by the debtor.

their plans or lack the financial discipline to do so. The same lack of funds or financial discipline will commonly lead debtors to neglect or defer needed, but often costly, maintenance of the collateral.

Also, even though contractually obligated to insure the collateral, hard-pressed debtors are also likely to skimp on insurance premiums, often resulting in cancellation or non-renewal of their policies. Lack of insurance on the collateral exposes their secured creditors to risk of uninsured loss or damage to the collateral or to the expense of buying insurance for themselves. Thus, when the Chapter 13 plans fail, and the creditor forecloses, or receives the collateral upon conversion to Chapter 7, it usually finds it has suffered a substantial loss during the delay caused by the failed Chapter 13 proceeding.

Congress rationally chose to make debtors compensate secured creditors for these additional risks inherent in Chapter 13 proceedings. That compensation is the required sharing with secured creditors of the enhanced value of collateral which debtors retain under their plans. In so doing, Congress conferred no windfall on secured creditors. They recover no more than what they are owed in any case, and in most instances considerably less. Congress has merely chosen not to make them suffer more extensive losses.

By contrast, the debtor will receive an unwarranted windfall, if allowed to retain the entire enhanced, reorganization value of the collateral. *See Dewsnup v. Timm, supra*, 502 U.S. at 417, 112 S.Ct. at 778; *In re Taffi*, 68 F.3d 306, 308 (9th Cir. 1995), *aff'd en banc*, 96 F.3d 1190 (9th Cir. 1996).



For good reasons, Congress decided to allow secured creditors to participate in the enhanced value created by reorganization. Its decision, as embodied in § 506(a) must be given effect.

## V

## SPLITTING THE DIFFERENCE IS NOT AN ACCEPTABLE RULE OF DECISION

The alternative approaches to valuation recently adopted by the Second and Seventh Circuits should be rejected for many of the same reasons the Court should reverse the Fifth Circuit's majority.

### A. The Seventh Circuit Wrongly Followed Game Theory Instead Of Congress' Directive

The Seventh Circuit's "split the difference" approach is founded on the premise that § 506(a) provides no meaningful guidance to courts in valuing the secured portion of an undersecured creditor's claim. *In re Hoskins, supra*, 102 F.3d at 314. As Judge Posner bluntly stated: "We get little help from the statute." *Ibid.*

Having cut itself loose from statutory guidance, the Seventh Circuit turned to economics and game theory to characterize the secured creditor's and the debtor's bargaining positions as a "bilateral monopoly" in which both parties are best off striking a bargain somewhere between liquidation value and replacement cost. *Id.*, at 315. Finally, the Seventh Circuit said that there is no way to predict where within that range an actual bargain would be struck, but that the midpoint – splitting the difference

– was a focal point to which parties would gravitate to avoid transaction costs. *Id.*, at 316.

The *Hoskins* opinion is, no doubt, ingenious, but it is flawed at the outset by its incorrect premise that § 506(a) provides "little help" in determining the value of the secured portion of an undersecured creditor's claim. As already explained, § 506(a) gives the needed guidance. The section's second sentence was added by the Senate and accepted by the House for the very purpose of providing the direction which the Seventh Circuit erroneously finds lacking.

Congress has decreed a method for ascertaining the value of the secured portion of the undersecured creditor's claim. It is pointless to speculate how the parties might bargain to reach a value in the absence of that statutory directive. Furthermore, bargaining position does not determine the value of a claim in bankruptcy. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 129-31, 60 S.Ct. 1, 14, 84 L.Ed. 110 (1939).

**B. The Second Circuit Incorrectly Abandons The Rule Of Law For Standardless Judicial Discretion**

The Second Circuit's recent decision in *In re Valenti, supra*, 1997 WL 31577, begins at roughly the same place as the Seventh Circuit and arrives at about the same result but by a totally different and equally inappropriate route.

Like *Hoskins*, *Valenti* begins with the proposition that § 506(a) is not helpful, failing to specify how courts should value the secured portion of an undersecured



creditor's claim. 1997 WL 31577 at 4. *Valenti* posits a conflict between the section's first sentence, which *Valenti* sees as pointing toward foreclosure value, and the section's second sentence, which *Valenti* views as suggesting replacement cost as the valuation standard for collateral retained by the debtor. *Id.* at 5.

Finding no resolution of the issue in the statute's terms, the Second Circuit, unlike the Seventh, decided not to impose a rule of its own making, believing "the correct result is that no fixed value, whether it be retail, wholesale, or some combination of the two, should be imposed on every bankruptcy court conducting a § 506(a) valuation." *Id.* at 6. Under the Second Circuit's approach each bankruptcy judge is free to decide for him- or her-self how to value retained collateral so long as he or she "considers" both the purpose of the valuation and the proposed use or disposition of the collateral. *Ibid.*

This approach is just as flawed as the Seventh Circuit's. Like *Hoskins*, *Valenti* begins by denying that Congress has said anything coherent on the subject. Instead of attempting to reconcile § 506(a)'s two sentences, *Valenti* presumes that Congress meant them to conflict with each other, leaving the courts with no useful guidance on the issue of valuing the unsecured portion of an undersecured creditor's claim. In doing so, *Valenti* violates a cardinal rule of statutory construction. *Federal Power Comm'n v. Panhandle E. Pipe Line Co.*, 337 U.S. 498, 514, 69 S.Ct. 1251, 1269, 93 L.Ed. 1499 (1949) ("If possible all sections of the Act must be reconciled so as to produce a symmetrical whole.")

Moreover, as the Seventh Circuit said in rejecting a similar *ad hoc* approach to valuation:

> [I]t is one thing to say that a uniform standard of valuation must be applied case by case, since application depends on the facts and they are different from case to case. It is another thing to say that there is no standard. Although there is some support in the legislative history for such an approach [citations], it would be peculiarly inappropriate to the valuation of Chapter 13 property. These are tiny cases. The debtor usually has few assets. To prevent the costs of bankruptcy litigation from eating up the entire debtor's estate, a simple rule of valuation is needed.

*In re Hoskins, supra*, 102 F.2d at 314.

In fact, the bankruptcy courts in the Second Circuit have already recognized the inappropriateness of the standard-less approach advocated in *Valenti* and have adopted their own standard by local rule, splitting the difference between wholesale and retail values except in unusual cases. *See In re Valenti, supra*, 1997 WL 31577 at 6. Thus, the net result of the Second Circuit's approach is to push down to an even lower and less appropriate level of the judiciary a decision regarding general rules and standards that should instead be, and were, adopted by the legislative branch. *See United States v. Noland*, ___ U.S. ___, 116 S.Ct. 1524, 1527-28, 134 L.Ed.2d 748 (1996).

Neither the Second Circuit nor the Seventh Circuit has paid proper deference to Congress' directive in § 506(a). Neither *Hoskins* nor *Valenti* adopts a proper interpretation of that section or a correct approach to



valuing collateral retained by a debtor under a Chapter 13 plan.

## VI

## CONCLUSION

For the reasons stated above, the Court should hold that a secured creditor, whose collateral is retained by the debtor under a Chapter 13 plan, has a secured claim to the extent of the fair market value of the collateral in the market in which the debtor would otherwise buy property of the same type to replace the collateral. This value must be reduced if the estate's or the creditor's interest in the collateral is limited.

Respectfully submitted,


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